The Obama Check-the-Box Proposal--Notice 98-11 Redux

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“Progress, far from consisting in change, depends on retentiveness.

When change is absolute there remains no being to improve and no direction is set for possible improvement: and when experience is not retained, as among savages, infancy is perpetual. Those who cannot remember the past are condemned to repeat it.”1

Well, a majority did, indeed, vote for the politics of change, not the politics of progress, so I guess we should not be surprised that the Obama Administration has re-proposed a change to the check-the-box (CTB) rules that was soundly and rightly criticized (and defeated) 10 years ago. Sadly, it appears that we are again presented with a proposal aimed chiefly at protecting other countries' tax bases from the depredations wrought by U.S. multinationals using our evil CTB rules. International tax aficionados are asking whether we may see history repeat itself.

This time, however, unlike when the same thing was proposed by the more principled Clinton Administration (how odd to be able to write that!) the rhetoric (demagogy?) is cloaked in the more strident tones of tax evasion and abuse rather than in the name of protecting the never-fully-endorsed concept of capital export neutrality.2 Equally important, unlike 10 years ago, there is an ample Democratic majority in both houses of Congress and the international tax lobbying muscle must deal with two other major proposals (the deferral of deductions allocable to deferred foreign income and the mega foreign tax credit pool) that will dilute the impact of any effort on the Hill to defeat the CTB proposal. As a result, the Obama Administration may well succeed where the Clinton Administration failed. It does not mean, however, that the criticism that 10 years ago defeated Notice 98-11 was wrong or that the proposal is not seriously flawed or even that the debate will be a fair or principled one.

As readers know, the Obama Administration has proposed that a foreign eligible entity may be treated as a disregarded entity (DE) only if the entity is created or organized in, or under the law of, the same foreign country as its single owner. However, “except in cases of U.S. tax avoidance,” the proposal would “generally” not apply to a first-tier foreign eligible entity wholly owned by a U.S. person. This proposal is essentially the same as the rule promised in Notice 98-11 -- that DEs used to make payments between

DEs disappear (and, therefore, avoid Subpart F, at least before the enactment of §954(c)(6)) would be treated as separate corporations.

The Treasury's Greenbook claims, in the "Reasons for Change," that the CTB rules "may result in the unintended avoidance of current U.S. tax" (emphasis added), specifically "the migration of earnings to low-taxed jurisdictions without a current income inclusion [under Subpart F]." Given the resolution of the debate following Notice 98-11 that forced its withdrawal, a moratorium on regulations implementing it and, eventually, the enactment of §954(c)(6), such a statement cannot be called anything other than pure fantasy. Of course this "avoidance of current U.S. tax" was intended! Not only was the strategy of using DEs to reduce foreign tax (without a Subpart F pickup) well-known, it was affirmatively used as the very reason Congress forced the withdrawal of Notice 98-11. Moreover, the enactment of §954(c)(6) was motivated in large part by the resolution of the debate over Notice 98-11 and the conclusion that that conclusion should be more widely available -- i.e., that stripping foreign tax bases by CFC payors of interest and royalties without a Subpart F pickup by the CFC recipient of the interest or royalties should be permitted wholesale, whether between DEs or between regarded CFCs.

The straightforward argument that won the day 10 years ago was that it is a good thingfor U.S. tax rules to encourage the reduction of foreign tax bases of subsidiaries of U.S. multinationals (by payments of deductible interest and royalties). The reason it is a good thing is that it will result in greater residual U.S. tax when the earnings are eventually repatriated (unprotected by credits for high foreign taxes imposed by the jurisdiction whose tax base the interest or royalties reduced). Indeed, §954(c)(6) was enacted to make this possible without using DEs. This concept -- that the payment of interest or royalties from a CFC earning active income to a CFC finco or licenseco should not cause an end to deferral -- is a common concept incorporated into many other countries' anti-deferral regimes.

For the Obama Treasury to now claim that this is an "unintended avoidance of current U.S. tax" is ridiculous. Indeed, such a statement borders on misrepresentation. Does no one writing or reviewing this stuff have a memory that is more than 10 years long? Is it possible that the current chief domestic policy/economic advisor in the White House forgot about an important tax policy debate that he lost 10 years ago when he was Deputy Secretary (and soon after Secretary) of the Treasury? It is inarguable that this is a change in policy and should be defended as one. It should not masquerade as a closing of an "unintended" "loophole." Even if it was one before 1998, after 1998 it clearly was not.

Compared to the Treasury's May 4 press release, however, the Greenbook's description of the anti-CTB proposal is a model of decorum. The press release puts the CTB proposal in a section entitled "Getting Tough on Overseas Tax Havens," together with proposals to catch tax cheats hiding income in foreign bank accounts. Guilt by association not being enough hyperbole, the press release goes on to describe the CTB planning -- planning that was specifically endorsed in the forced withdrawal of Notice 98-11 and the later enactment of

§954(c)(6) -- as a “loophole” that allows U.S. businesses to “pretend”

that foreign subsidiaries do not exist -- terming these affiliates “disappearing offshore subsidiaries.” It goes on to make the completely unsubstantiated (and unsubstantiable) claim that “[i]t is clear that this loophole, while legal, has become a reason to shift billions of dollars in investments from the U.S. to other countries.”

These statements go well beyond normal hyperbole used to advocate a tax policy position. They misrepresent the policy debate over precisely this proposal (a debate that took place only a decade ago) by ignoring it entirely, as if it never took place. Moreover, they sling mud on what is not only a clearly legal planning technique, but one that's defensible on policy grounds endorsed by Congress only a few years ago. This borders on shameful. Sure there's been an election and the new Administration is perfectly justified in proposing changes to policy, even (or perhaps especially) recent policy. But to frame the issue in the way the Obama Administration has framed it is both phony and unnecessary. Why not just revisit the policy debate over Notice 98-11? There are policy arguments on both sides. They should be fully and fairly aired.

It is clear, however, that the Administration is not interested in a fair debate over debatable policy choices. They roared out of their corner in the very first round of this fight with the verbal equivalent of biting, kicking, and gouging. More appalling, reportedly they had the gall to request, privately, that the larger companies concerned about these proposals not “go nuclear” in their response to them. Such an approach reveals a deep cynicism about the tax policy political process. It also reveals a lack of confidence that the CTB proposal can be defended on policy grounds. The companies reacting to these proposals are fully justified in responding in kind. Whatever one thinks about the wisdom or lack thereof of applying CTB in many international contexts, any rational international tax expert should be saddened by the way this fight was inaugurated by the Obama Administration. And perhaps emboldened to use the harshest sort of criticism in resisting this proposal.

This commentary also will appear in the August 2009 issue of the Tax Management International Journal. For more information, in the Tax Management Portfolios, see Streng, 700 T.M., Choice of Entity, and Yoder, 927 T.M., CFCs -- Foreign Personal Holding Company Income, and in Tax Practice Series, see ¶7130, U.S. Persons' Foreign Activities.

1 American philosopher George Santayana (1863-1952), “Life of Reason I.”

2 Never fully endorsed because no one has ever seriously proposed an unlimited foreign tax credit, a necessary part of capital export neutrality.